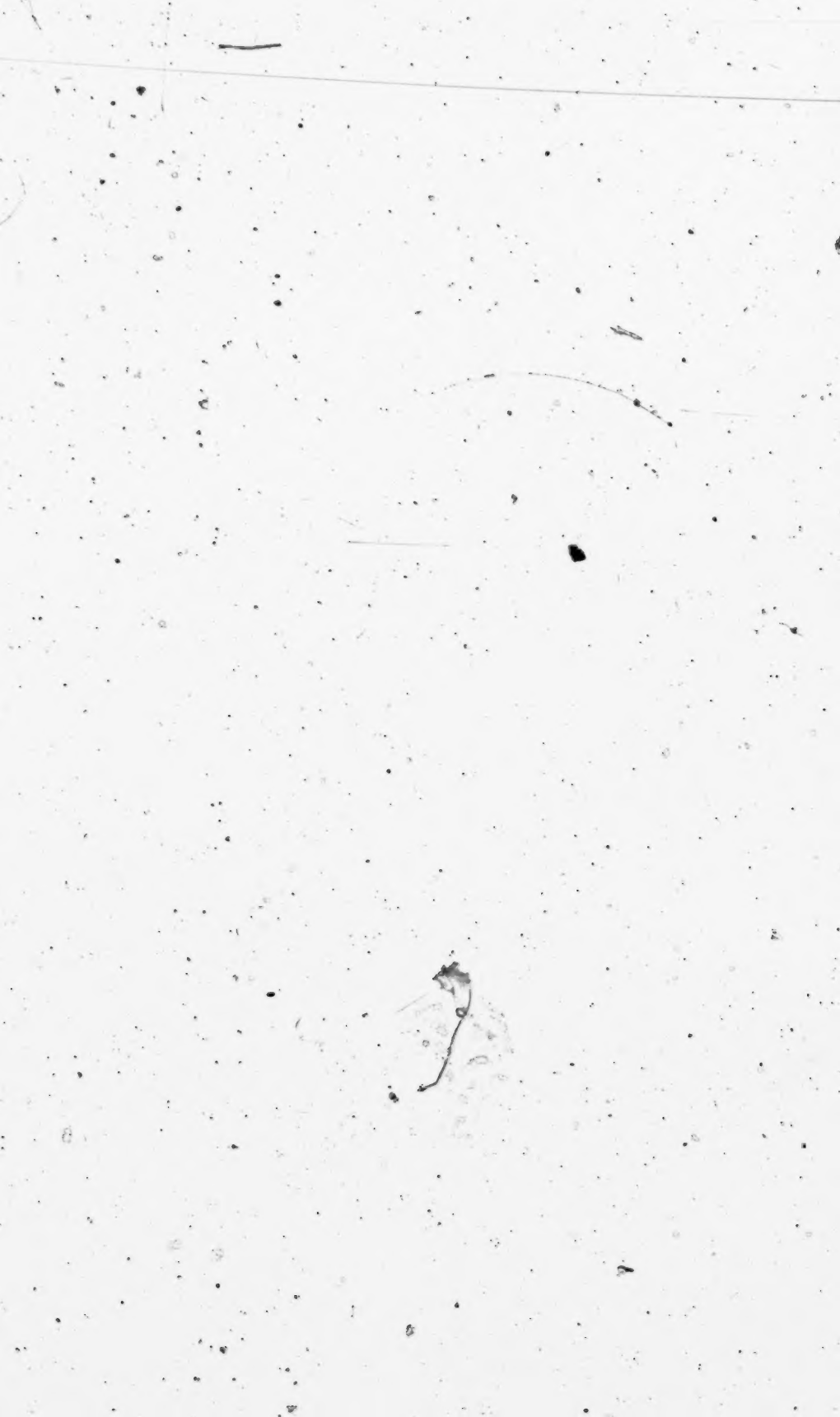

FILE COPY

FILED
OCT 14 1942
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

Nos. 11-19, 32

IN THE MATTER OF

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY,

Debtor.

GROUP OF INSTITUTIONAL INVESTORS AND MUTUAL SAVINGS BANK GROUP,

Petitioners,

vs.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, ET AL.,

Respondents.

BRIEF OF AMICUS CURIAE

WILLIAM V. HODGES,

Amicus Curiae.

October 12, 1942.

THE BRADFORD-ROBINSON PTG. CO., DENVER

IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

Nos. 11-19, 32

IN THE MATTER OF

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY,

BRIEF OF WILLIAM V. HODGES AS AMICUS CURIAE

FOREWORD.

By the provisions of a plan for the reorganization of the St. Louis-San Francisco Railway Company its unsecured creditors and its stockholders are eliminated from future ownership. True, the District Court returned the plan to the Commission, but its opinion can be read as being adverse to those unsecured creditors and stockholders. These stockholders recognize that the opinion of this court in this case may settle all the questions involved in the position which they have maintained. They desire the privilege of presenting some questions which may not be urged by other railroad debtors.

On the date when the petition for reorganization was filed, the stockholdings of the Frisco represented a bona fide investment of approximately $90,000,000 in excess of all debts due on that date. For many years prior to the depression its property rendered and now is rendering a transportation service in volume and value which in the

earlier period required at least a normal use of its full plant and now requires a peak use thereof. This debtor reminds the Court that the threatened loss of its entire equity is not to be the result of the enforcement in equity of any covenants it has made consenting to the forfeiture of its property rights for non-payment of debts. The loss is threatened as a result of the assumption by the Interstate Commerce Commission of the power, with the approval of the Court, to value (?) its property by standards heretofore unheard of, to compare that value with its debts augmented by an accumulation of interest on its debts at contract rates during the period of administration and to suggest (not find) that the aggregate of such debts exceeds this new concept of value and to exclude the stockholders from any share in the property. If Congress ever intended such a proceeding with such a result, we believe it is not stated in Section 77.

The distressing anxieties of the depression were largely made up of distorted debtor and creditor relationships. Men adjusted those relationships, forgiving and extending, compromising and adjusting, indebtedness. This was the great natural healing process. Moratorium laws were enacted to aid and encourage this process. While the laws accomplished something, it was much less than what was accomplished by human compassion and decency. The process was not easy to bring about where a debt was split and held in multiple hands. Such was the character of corporation debts.

There is every evidence in Sec. 77 and the record of its legislative progress to indicate that its objective was "for the relief of debtors". It gave opportunity to bring debtors and creditors into a composition; to permit them to make fair agreements readjusting their debts and the security therefor under the aegis of bankruptcy principles.

As to railroads, the anticipated, inevitable readjustment of fixed charges calls logically and properly for the arbitrament of the Interstate Commerce Commission. There was reason for having the agreements between debtors and creditors made under the scrutiny of the Commission to the end that men should not be brought to agreement

without full knowledge of relevant facts and that their agreement should be free. There was reason and finality of objective in having the agreements made in bankruptcy wherein ancient principles peculiar to bankruptcy, and older in the art than the *Boyd* case rule, should be used as a test for fairness and that minorities could be bound under that test. The rule of the *Boyd* case so far as it had been established was purely negative; its affirmative use as a principle for binding minorities had never been authenticated.

If such was the purpose of the Act, that purpose has been wholly frustrated. Provisions of the Act which, measured by that purpose, are anachronisms, have served to dominate its interpretation and make of reorganization proceedings a series of steps by which a body created by Congress formulates a plan of reorganization to fit its notion of public interest, for which it finds no definition either in the Constitution or in laws of Congress, ignoring rights which are purely private, violating the principles of bankruptcy administration, and flouting the law of the land. The theory now advanced is that the Commission may formulate a plan of its own; that it may exclude from participation any interest which by its newly devised measure of value, not clearly disclosed, has no equity; that it may distribute securities irrespective of any desire which security holders might have to make their own agreements with the debtor; that whether the security holders vote by classes in favor of the plan or not, the court may accept the judgment of the Commission and by fiat make the plan effective.

It must be remembered that only minorities of bondholding classes are represented by the institutional committees which have dominated most of the Section 77 proceedings. The Act has been so administered that the organization of majority committees has been made impossible in practice.

The Interstate Commerce Commission has so applied the Act that there is not the remotest chance for any railroad debtor to secure relief. The very status which was supposed to qualify it to ask for relief is held to justify a death stroke. Contrariwise the pathway of security holders is made easy; they secure the full benefits of the forfeiture clause

of their covenants without proceeding in accordance with those covenants and without assuming any of the burdens, legal and economic, which, under those covenants, they must assume.

Security holders have been awarded a streamlined foreclosure more harsh than the old strict foreclosure. All the enlightened, equitable policies enacted in modern legislation for protection against harsh forfeitures through foreclosure have been brushed aside.

If there is to be forfeiture and not composition, it should only be arrived at after an unchilled sale, and the court should deal only with the proceeds of such a sale, definite in amount and distributable in accordance with rights. Stockholders are being subjected to forfeiture by purported valuation (under the guise of capitalization). By all equitable concepts such a proceeding is not within the competency even of a court of equity. The injustices magnify when man, whatever his rank or title, tries to assume future value for the purpose of taking someone's property. It is future value with which the various owners of the debtor's property are dealing and that value is not humanly ascertainable. Any attempt to guess at it is too far beyond the realm of probability to be used as a basis for wiping out the ownership of honest investors.

Experience with the special Act passed for the relief of the Baltimore and Ohio and other railroads, but denied to others, shows that composition is practical. If in any case it is not, the court should dismiss the proceeding and relegate the parties to equity. An attempt at real composition has not been made, nor is it possible in most if not all of Sec. 77 cases, as that Act is applied by the Interstate Commerce Commission.

I.

If it is in accordance with the law of the land to value the debtor's property in these cases and forfeit the debtor's interest, the determination of value is for constitutional purposes and is a judicial question; such valuation cannot be made by administrative fiat.

In considering the reorganization plans developed under Section 77 of the Bankruptcy Act, we start with the proposition that the function of the Court is entirely separate and independent from the function of the Interstate Commerce Commission. The Court judicially must be satisfied that the plan conforms with the requirements of Section 77. It is not enough that the Interstate Commerce Commission shall announce its opinion; the Court must exercise its own independent judgement, not only as to the public interest, but as to all other features of the plan.

A second premise is that the determination of "value" is a judicial question. The owner of property is entitled to have the value of that property for any purpose determined by the judicial process, which the Commission has no power to exercise. As this Court said in *Baltimore & Ohio R. Co. v. United States*, 298 U. S. 349; 80 L. ed. 1209:

> "The just compensation clause may not be evaded or impaired by any form of legislation. Against the objection of the owner of private property taken for public use, the Congress may not directly or through any legislative agency finally determine the amount that is safeguarded to him by that clause. If as to the value of his property the owner accepts legislative or administrative determinations or challenges them merely upon the ground that they were not made in accordance with statutes governing a subordinate agency, no constitutional question arises. But, when he appropriately invokes the just compensation clause, he is entitled to a judicial determination of the amount. The due process clause assures a full hearing before the court or other tribunal empowered to perform the judicial function involved. That includes the right to introduce evidence and have judicial findings based upon it."

Section 77 (b) (4) requires that fixed charges under a plan of reorganization shall be such that there shall be adequate coverage thereof by the probable earnings available for the payment thereof. This is the only mandatory requirement concerning the new capitalization. Section 77

is silent as to the total capitalization to be provided under the plan, and it does not confer upon the Commission any express power with reference thereto. When the Commission undertook to fix maximum capitalizations on the basis of what it considered the "capitalizable value" of the assets, it was performing a judicial function, and when in the process, it excluded debtors and their stockholders from ownership, it deprived those debtors of their property without due process of law, and ignored the fundamental implications of the bargain between the investors and the public.

The carrier which devotes its property to the public service thereby enters into a pact with the public that it will furnish adequate service, at reasonable rates, without discrimination; that it will submit to public regulation of those rates, its operations, its investments, its new constructions and it abandonments. Under our present laws, no carrier can enter into public service without a certificate of convenience and necessity. Having once devoted its property to the public service, it cannot withdraw that property from such service without the approval of the Interstate Commerce Commission. Clearly appropriate to this situation are the words of Mr. Justice Brandeis in his opinion in *Southwestern Bell Telephone Company v. Public Service Commission of Missouri*, 262 U. S. 276, in which Justice Holmes concurred:

> "The owner is at liberty, in the absence of controlling statutory provision, to withdraw his property from the public service; and if he does so, may obtain for it exchange value. * * * But so long as the specific items of property are employed by the utility, *their exchange value is not of legal significance.*"

The carrier receives just one thing in return, — the assurance, not written out in the statutes, but firmly embodied in the Fifth Amendment that the property so devoted to public service will not be taken from it without just compensation, that so far as the public is concerned it will be allowed to earn a reasonable return on the *value* of that property. It may not be deprived of this property by a

confiscatory rate regulation; likewise, it may not be deprived of this property by an arbitrary determination of its capitalization. To take from the carrier this guaranty is a taking of property without due process of law. It is being accomplished in these pending reorganizations through the Commission's arbitrary conclusions as to permissible capitalization.

This country has developed because the railroads have developed. The men who built them furnished to the communities served by them an essential asset scarcely less vital than light and air. The investment of capital in the transportation system is quite a different thing from the investment of private enterprise. The time element in the business life is altogether of a different sort from the time element in the life of a utility. A man may start a drug store and within a reasonably short time must make it pay and if it is not made to pay and kept on a paying basis it ceases to be a community asset or of any benefit to the owner, and it will be liquidated. A railroad is, and is intended to be, a continuing asset which, for various reasons, may not be used to anything like its capacity for a long period of time. It still remains a necessary asset for the community, so long as there is any likelihood that the community will exist as a user. But, regardless of the needs of the individual community, the railroad, as a part of the national transportation system, always must be maintained in condition for peak service.

We have an example today: the backbone of national defense is the transportation system. No one can envisage the calamity which would have befallen the defense program if that transportation system had not been ready to handle a peak load very much larger than that prevailing throughout the depression, or that contemplated by the Commission's theories, whatever they may be, as the "value of the assets for the purposes of capitalization". It is obvious that this national transportation system, including the thousands of miles of railroad now in the bankruptcy courts, must in the interest of national defense and the postwar program be maintained at its present capacity for many years to come. If these reorganizations had proceeded upon the

basis of the "capitalizable values" used by the Commission in its plans, and if the railroad plant had been adapted to handle only such traffic as the Commission foresaw in determining these "capitalizable values", we would now be in the midst of a national disaster.

Proceeding under the theory that under Section 77 it has the power to determine the total permissible capitalization, which it always finds to be less than the existing capitalization, or the bona fide investment in the property, the Commission has in fact destroyed a large part of the securities representing the owners' investment in the transportation systems. It has made no findings of value. In one case, it is stated that the proposed capitalization stated in dollars "fairly represents the worth of assets that will be devoted by the reorganized company to the service of transportation", *Rock Island Reorganization*, 242 I. C. C. 437. Later in the same case, it arbitrarily increased this amount, and said that the new amount "represents a fair estimate of the value of the system's assets for purposes of valuation", 247 I. C. C. 533, at 540.

In the Frisco case (*St. Louis-San Francisco Ry. Co. Reorganization*), 240 I. C. C. 383, at 406, the Commission merely said:

> "Considering the entire record and taking into account the reproduction value of the property remaining in service after the abandonments and the favorable past earnings, as well as the unfavorable recent earnings, would appear that the total capitalization after reorganization should be about $240,000,000."

This has been its procedure in all cases. The result is a confiscation of property. The Commission has in no case followed the mandate of the statute that it shall fully state the reasons for its conclusions, but has fixed these capitalizations with a stroke of the pen. Its fiat has gone forth; the permissible capitalization is so much.

No one can question that, if the Commission fixed the permissible capitalization of the Frisco at, say, $50,000,000, there would be a taking without due process, but the difference between the fact and the illustration

is one of degree; not of principle. No one in the world can tell from the Commission's reports in the cases cited, or in any of the reorganization cases, what the Commission's idea is of the relation between value and capitalization. In every case, it has fixed a capitalization which, with due solemnity, it assures the world represents its idea of what a fair capitalization should be. This solemn utterance, however, is a death sentence to the stockholders who have invested their money in the property.

An even more startling suggestion is made in these cases by the groups of institutional investors which now assert that the Commission need not in any case fix a dollar value upon their claims, but shall merely estimate that the "value" of the new "bundle of securities" which the creditors will receive is equal to the "value" of the old "bundle of securities and rights" which they will surrender. No standard of comparison is suggested. No common denominator is possible; under this theory it will be sufficient if the Commission either through a "finding" or some necromancy shall say that "this bundle is of the same value as that bundle".

If we are to have the rights of parties determined in such a manner, then all law and order in this country is at an end.

II.

Regulated earnings are no measure of value.

The Commission has made no findings of value in these cases. In no case has it stated the "reasons for its conclusions". It has professed to base its capitalization upon its conception of earning power as mentioned in Section 77 (e), but it has in no case certified to the Court, as required by that Section, the "value" based thereon. Its conception of "earning power" has been guided by the actual earnings of depression years; not by earning power itself, or a broad grasp of what that term really means. In cases where a capitalization based on demonstrated earnings would exceed the other elements of value which are required by Section 77 (e) to be taken into account,

the Commission has forgotten about the earnings, as notably in the Frisco case, and put its emphasis upon reproduction cost less depreciation, obviously because that was lower.

It has been uniformly recognized that a railroad has no exchange value. There is no market for a railroad. This absence of market is not refuted by the fact that there may be a market for railroad securities and stocks.

The decisions in the rate cases which have laid down the basis for valuation have authoritatively fixed a basis which applies to any situation wherein the property is being taken from an owner and given to the public, or taken in the public interest from one man and given to another.

Many economists have written articles which assume that the courts were trying to regulate rates in these cases, and that what has been said in regulating rates has no application to a value in reorganization. We submit that the courts were never attempting to regulate rates. In the rate cases they were confronted with the sole question: "What is the value of this kind of property which cannot be taken?" Their task was to find that value. When they found that value, they merely said that rates which took that value without compensation were unconstitutional. The determination of that value did not depend on whether the property was being taken by rates, by condemnation, or by the fiction of prescribing permissible capital in reorganization.

Our position does not depend on the question whether reproduction value or investment value is the proper basis.

Certainly in determining that value the Supreme Court in its maturer decisions rejected *regulated* earnings as a test. Mr. Justice Brandeis, in the *Southwestern Bell Telephone Company* case, made that very clear.

We have all had experience with the use of earnings as a basis for valuing private property having an exchange or market value. In these cases, the whole reason for using earnings was to determine a market value. But is there reasonable ground for going through the process of

capitalizing earnings with the realization that there is *no* market value for a railroad property? This Court has repeatedly rejected the idea that a railroad has a market value.

Section 77 (e) does emphasize "earning power" as one of the factors of value. "Earning power" is quite distinct from "earnings".

Neither "earning power" nor "future earnings" are susceptible of human estimate. Anyone who has a force of skilled researchers at his command could uncover a mine of instances in the cases before the Interstate Commerce Commission where so-called expert testimony and so-called expert determinations by the Commission have been demonstrated by events to be ludicrous. Too many forces, governmental and natural, are at work, and too many unexpected factors come over the horizon for any sincere mind to pretend to forecast earnings beyond a very short period of a year or two. That the Interstate Commerce Commission is endowed with the gift of prophecy is a fallacy that needs to be mentioned only to be exposed. The Railway Age for September 26, Vol. 113, No. 13, page 488, contains an article by Fairman R. Dick, one of the country's leading authorities on railroad finance, entitled "Reorganizations —Do they restore credit or destroy it?", which cites several instances of the failure of the Commission's prophecies in matters of the utmost importance to the transportation system. In the Rock Island reorganization case, the Commission, after a lengthy discussion of estimates and forecasts, concluded that $100,000,000 a year would be a normal year's revenue for the Rock Island, and that, of this amount, $11,000,000 would be available for interest and dividends. In the same year in which this prophecy was made, the operating revenues were some $96,900,000, which was less than the Commission's forecast of a normal year, but the net income was $18,149,000, more than 60 per cent of what the Commission forecast would be derived from substantially the same gross revenues. It cannot be claimed that the war boom is responsible for this, because the gross revenues were less than the Commission considered normal!

Many more instances of this kind can be found in the reorganization reports of the Commission.

In many cases, we have been concerned with the proper basis for capitalizing earnings to determine the value of property having a market, and when we could find a rate of return sufficient to attract capital we would use that rate of return to capitalize earnings. Certainly earnings are no help unless we can have the other factor necessary to use with it.

But can anybody tell us what rate of return today is necessary to attract overall capital to the creation of a railroad in face of the destructive force of affirmative regulation, and the neglect of regulation of competitive industries, and the use of the source of regulative power to impose taxes and to raise wages? All of these governmental forces brought into play have made it impossible to raise overall capital. The courts and commissions have been grabbing out of the air a percentage to be used as a factor in capitalizing earnings. The factor is wholly arbitrary, and has no reference to the only test which can justify the selection of such a factor, to-wit, a rate of return sufficient to justify investment. The resulting capitalization arrived at as a result of these processes is of necessity arbitrary and unreal. The device of using prospective earnings of a regulated industry for capitalization to find a value is likewise unreal. The whole process is a transparent subterfuge to obscure the denial of constitutional protection.

It seems to us that the vicious circle will require the rejection of the regulated earnings of any property, public or private, as a test of value.

Furthermore, in the case of a railroad, the earnings base is not valid for the further reasons:

(a) That that there is no exchange or market value for such property.

(b) The property is created to serve a community need of fluctuating intensity and so long as the community keeps it as an asset the sovereign's

test of its value should be equivalent to what, were it not there to serve, it has required or would require to produce it.

(c) The earning *power* base is not humanly ascertainable, except by the formula of investment (or reproduction value) times fair rate of return.

(d) "Regulated earnings" is not an attribute of the property; it flows from government fiat, and fair and constitutional valuation must be based on the property's own attributes, uninfluenced by the adverse weight of governmental force in the form of special laws.

III.

The effective date of the plan.

One of the most grievous respects in which the Commission and the lower courts have erred in their treatment of these plans of reorganization is in the allowance of accumulated interest on the claims up to the so-called effective date fixed by the Commission in its plans. Section 77 (1) provides:

> "In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the Court, the duties of the Debtor and *the rights* and liabilities *of creditors* and of *all persons* with respect to the debtor and its property shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been *entered on the day when the debtor's petition was filed.*" (Italics ours).

This language precludes the allowance of interest in full between the date of filing the petition under Section 77, hereinafter called the "basic date", and a date arbitrarily chosen by the Commission some four or five years later. For instance in the *Frisco* case the basic date was May 16, 1933; the effective date was January 1, 1940. In the Rock Island case the basic date was June 7, 1933; the effective date January 1, 1942. In the Milwaukee case the

basic date was June 29, 1935; the effective date January 1, 1939. Surely the law never contemplated these differences, and, as we shall show later, the legislative history of the statute precludes such a construction.

The effect of this construction of the statute is utterly destructive of the rights of stockholders and junior creditors. It means that the burden of the debtor's obligations is increased every year by the amount of the annual interest charges on the old debt. The lower courts and this court have pointed out that prompt reorganizations were one of the primary purposes of the Act; but some of these cases are in the tenth year in the courts.

Nothing is said in Section 77B or its subsequent amendments to expressly include or exclude interest subsequent to the filing of the petition in reorganization as a part of the claim to be recognized in the distribution of new securities. If, in the *Rock Products* case, the Court was speaking of interest after that basic date, it was because of some assumed implication in that section. The legislative history of Section 77 precludes such an implication.

As Section 77 originally stood, it defined in paragraph (b) the terms "securities," "stockholders" and "creditors," the latter being defined as follows:

> "The term 'creditors' shall except as otherwise specifically provided in this section, include, for all purposes of this section and of the reorganization plan, its acceptance and confirmation, all holders of claims, interests, or securities of whatever character against the debtor or its property, including claim for future rent, whether or not such claims, interests or securities would otherwise constitute provable claims under this Act."

When the 1935 amendments were being considered, they were originally presented in the House, in the form of H. R. 6249, introduced by Mr. Sumners of Texas on February 27, 1935. This bill not only defined "securities," "stockholders," and "creditors," but also added a definition of "claims," as follows:

"The term 'claims' includes debts, securities other than stock and option warrants to subscribe to stock, liens, or other interests of whatever character."

After consideration and several public hearings by the Committee on Judiciary, the bill was revised in many particulars and re-introduced by Chairman Sumners, of the Judiciary Committee, on June 20, 1935, as H. R. 8587, accompanied by Committee Report No. 1283. It contained definitions of "securities," "stockholders," "creditors" and "claims," "claims" being defined as follows:

"The term 'claims' includes debts, whether liquidated or unliquidated, securities (other than stock and option warrants to subscribe to stock), liens, or other interests of whatever character, *including interest thereon accruing after the filing of the debtor's petition.*"

(See H. R. 8587, p. 8, lines 18 to 22, inclusive, Committee Report No. 1283, p. 12, par. (2).) It will be seen that the Committee had changed the language of the original draft, and had added the words which we have italicized.

When this bill was reached for consideration in the House, the Judiciary Committte, through Chairman Sumners, introduced certain Committee amendments, including the following:

"Page 8, line 21, after the word 'character' strike out the remainder of the sentence."

This amendment was agreed to (Congressional Record, August 15, 1935, p. 13777, column 2).

In other words, that part of the definition of the term "claims" reading "including interest thereon accruing after the filing of the debtor's petition" was stricken out, so that the section now provides:

"The term 'claims' includes debts, whether liquidated or unliquidated, securities (other than stock and option warrants to subscribe to stock), liens, or other interests of whatever character."

Congress has, therefore, by its expressed intention eliminated from the definition of the word "claims" all reference to interest accruing since the filing of the petition. No case of legislative intent could be clearer.

There is ample authority for the position that such amendatory action in the process of the passage of the Bill (there being therein no other clear language to the contrary) is equivalent to a provision that no such interest shall be included. If there were in the Bill clear language indicating that, contrary to bankruptcy practice, interest during administration should be incorporated as part of a creditor's claim, the situation would be different. There is no such language in Section 77, and, in the light of the legislative amendment, no such recognition of interest can be implied.

In *Carey v. Donohue*, 240 U. S. 430, Justice Hughes stated the rule:

> "* * * we are not at liberty to supply by construction what Congress has clearly shown its intention to omit." (240 U. S. 436).

The same reasoning was adopted by Mr. Justice White in *U. S. v. Delaware & Hudson*, 213 U. S. 366, at 414, by Mr. Justice Lamar in *Pennsylvania R. R. Co. v. International Coal Mining Company*, 230 U. S. 184, at 199, Mr. Justice Sanford in *Hecht v. Malley*, 265 U. S. 144, Mr. Justice Cardozo in *Fox v. Standard Oil Co.*, 294 U. S. 87.

Any other result is unsupportable in reason. The rule, as stated, has uniform support in the authorities.

We do not run counter to the *Rock Products* case when we insist that the reorganization process should be applied to the capital structure as it stood at the basic date, and that the new securities be issued to creditors on their claims as they stood at that date. The power of the courts so to do cannot be denied. On this one point turns the question whether a debtor shall have the equity which it had at the time it came to the court for refuge, or shall find that that equity has been reduced by a constant accumulation of its debt during the administration by the Court.

The power to reject interest accrued even prior to the filing of a bankruptcy petition was clearly confirmed in the *Gebhard* case and the forgiving of interest was one of the possible reliefs to debtors contemplated by Congress. See *Continental Illinois National Bank v. C. R. I. & P.*, 294 U. S. 648.

This Court admitted Section 77 into the company of constitutional acts and gave as the reason for doing so that the Act is an exercise of bankruptcy power, calls for bankruptcy jurisdiction, and contemplates composition in bankruptcy. The treatment of creditors' claims in bankruptcy in respect of interest differs entirely from the treatment in equity receiverships. See *Merrill v. National Bank of Jacksonville*, 173 U. S. 131, 43 L. Ed. 640. In bankruptcy the property is turned over for creditors and their rights are thereafter *in rem*, and no contract interest accrues thereafter.

In *Board of County Commissioners v. Hurley*, 169 Fed. 92, at 94, Judge Sanborn defined the legal effect when property is turned over to a bankruptcy court for administration, as follows:

> "On that date the property of the bankrupt passes from his control to the court or its receiver and thence to the trustee in trust for the creditors of the bankrupt in proportion to the amounts of their claims at that time. On that date there vests in each creditor as a *cestui que trust* an equitable estate in such a part of the property of the bankrupt as the amount of his provable claim at that time bears to the entire amount of the provable claims against the estate. On that date the bankruptcy law deprives the creditor of all his common law remedies to collect his debt out of the property of his debtor and to collect subsequent interest on his claim against that property, and gives him in lieu thereof this equitable estate in the property of the bankrupt. * * * Indeed the condition at the time of the filing of the petition measures the extent of the estate and the right of all creditors of the bankrupt and all parties interested in the property throughout all the provisions of the law."

It would seem to follow that after the application of the bankrupt's property to the payment of his debts in the manner prescribed by Judge Sanborn, any accrual of interest on the principal debt after that date would be equivalent to allowance of interest on an obligation paid at least in large part.

Judge Sanborn was stating in his own way the rule laid down in *Sexton v. Lloyd's Bank*, 219 U. S. 339; 55 L. Ed. 244. In this case Justice Holmes had before him one party who had a lien on a bankrupt's estate and had foreclosed it and asked to be permitted to prove for the balance due him. In making the computation he contended that he should be permitted to add interest to his claim for the period following the filing of the bankruptcy petition and ending with the date of the sale of the security. To this claim Justice Holmes replied in effect:

> "You cannot add the interest which you claim. No contract obligations accrue after bankruptcy. Your right is *in rem* to a distribution of the estate in the proportion which your provable claim bears to the other provable claims as of the date of bankruptcy."

Another party having a lien on part of the bankrupt's estate foreclosed and likewise sought to prove for a deficiency. His case differed from the other creditor because the security which he held had produced income subsequently to the date of bankruptcy. He was permitted to apply that income to interest after the date of bankruptcy. However, his claim against the bankrupt's estate was limited to the principal and interest thereon accrued to the date of bankruptcy less the amount realized by the sale of the property.

There was no hint on the part of Justice Holmes that the rule was merely one of convenience in administration. It is a substantive rule of equity. There are a multitude of decisions holding that a lienor has the right to foreclose upon his property although the Debtor is in bankruptcy and that out of the proceeds of foreclosure sale he can pay interest accrued since the date of bankruptcy.

A secured creditor in bankruptcy can retain his security and through sale or the income from his security pay his claim in full, including interest to the date of payment, but he cannot do this and share in the general estate except for a deficiency in the computation of which interest after the basic date is not computed. Under Sec. 77 a secured creditor can retain his lien and still share in the general estate. If during that period he is allowed the earnings on his security, he has all that the bankruptcy law has ever accorded him plus the privilege of sharing in the general estate on the basis of his entire claim. He may be awarded the earnings on his security in various ways. Ordinarily the interest on the new securities received by him in reorganization computed from the basic date is not less than the equivalent of those earnings. If the object of Sec. 77 was liquidation, there would be support in the law of bankruptcy for allowing interest to common creditors before the return of any assets to debtors. A secured creditor would then have interest but only on the basis of the provability of the excess of his claim over the amount realized on his security, and that interest would lie in equity and not in the recognition of a contract rate. There is no justification for the allowance of that interest when the object of the bankruptcy proceeding is not liquidation but reorganization and the issuance of evidences of property rights the future value of which is wholly unascertainable and may well more than compensate for interest.

The equivalent of the right of a lien creditor to the income on his security realized during the administration of the trust estate is found in the interest on new securities to be issued as of the basic date.

In the proceeding now before the lower courts the parties are asking for a division of the bankrupt's estate in accordance with priorities, but each expects to share in the whole. The bankruptcy principle which insists on equality must not be violated by changing the claims from day to day through varying contract rates of interest. The declaration of Justice Holmes that no further con-

tract rights accrue because they become rights *in rem* is appropriate and fundamental.

We have made the argument above that the action of the House in specifically amending Section 77 demonstrates that the objective of that section did not embrace the recognition of interest after administration as a part of a claim. Even in the absence of such a clearly supporting circumstance we find in the fundamental scheme of Section 77 no place for a consideration of such interest. If it is within the discretion of the Court to fix the effective date of the Plan, that discretion is inconsistent with any *obligation* to allow new securities for interest accruing on old securities after the filing of the petition for reorganization.

Over and above all these considerations the ultimate object of the Act is not liquidation and payment. The object is "relief to debtors" and the process is the distribution of new securities representing a continuing right and interest in the property. Realization on such securities is left to the future. Human foresight cannot say that these securities will not eventually pay the whole debt of every creditor. This represents a difference of great significance between the objective of ordinary bankruptcy laws and the objective of Section 77.

If interest after basic date is allowed to accumulate for the benefit of prior claims we find that through the operation of the statute and the processes prescribed by it, huge accumulations of interest are added to the Debtor's burden. To so administer the Debtor's estate defeats *pro tanto* the relief contemplated. Apart from all legal concepts, such a result would appear to a layman as grossly unjust. Equity should avoid it if possible. Interest at a new rate from the basic date will be paid in cash or funded through the new securities to be earned under the Plan.

By the decision of this point adversely to the debtor this Court can take away from the debtor's stockholders in the *Frisco* case the huge sum of $90,000,000. The Congressional history of the Act, the equitable principles of administration in bankruptcy, the equitable considerations

which set a Chancellor against compounding interest, the equitable principles which for all time have impelled Chancellors to resist harsh measures and harsh forfeitures, speak against a construction of Section 77 which permits interest during administration to be accumulated.

Respectfully submitted,

WILLIAM V. HODGES,
Amicus Curiae.

October 12, 1942.